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City and County of San Francisco

Office of the Controller - Office of Economic Analysis

Eastern Neighborhoods Area Plans: Economic Impact Report **October 7, 2008**

Main Conclusions

The Eastern Neighborhoods Area Plans involve a significant re-zoning of areas in East SoMa, Showplace Square/Potrero Hill, the Mission, and Central Waterfront areas. Re-zoning primarily impacts the economy by affecting the amount of land, and real estate, that can be devoted to different economic activities. These decisions ultimately affect the rents that residents pay for housing, factories and warehouses pay for industrial space, and commercial businesses pay for office and retail space.

In the Eastern Neighborhoods plans, the most economically significant change is the more restrictive zoning that is proposed to be applied to the City's industrial lands. While permitted building heights are rising in other areas of the plan, particularly along Mission Street and in East SoMa, they are also being lowered in other non-industrial areas. The vast majority of the net change in property value will occur within the former industrial zones.

Under the current zoning, which dates back several decades, industrial uses are permitted on these lands, but so is office development, retail, and, with a conditional use from the Planning Commission, residential development.

This permissive zoning is proposed to be replaced in two main ways. First, a set of Mixed Use zones is proposed, where, in general, office use is restricted, but housing is encouraged with greater affordability requirements than elsewhere in the City. Second, Production, Distribution, and Repair (PDR) zones are proposed that prohibit new housing and office development, and protect industrial businesses.

The Mixed Use zones are intended to maximize the production of housing, especially affordable housing. The PDR zones are intended to prevent the further decline of blue-collar employment in San Francisco, which is the highest-paying source of employment for the 50% of San Francisco adult residents who do not have a four-year college degree.

The direct economic impact of this re-zoning can be estimated by simulating a "build-out" scenario of the current and proposed zoning of the former industrial lands, and comparing the difference. This simulation model works off the assumption that different permitted uses compete for land, and the land will be developed for the use that can afford to bid the most for it.

The build-out of the Eastern Neighborhoods, under either the current or proposed zoning, would likely take several decades, and even under the proposed zoning there would be considerably more development than exists there today. However, the proposed plans would significantly restrict future development, leading, in particular, to a slower rate of employment growth, and lower property taxes, than would be the case under the current zoning. The economic cost of the plan, in other words, should be viewed as foregone future growth, rather than an actual economic loss to the city.

Notwithstanding the timeline, the magnitude of the difference is substantial. At a build-out of the

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industrial lands under the proposed zoning, there would be 29 million fewer square feet of office space, and 116,000 fewer office jobs. This equals about 20% of all current wage and salary employment in San Francisco, to put it in perspective. Over the past 20 years, the Planning Department estimates that 3.5 million square feet of office space has been developed in the Eastern Neighborhoods. While that rate of development could increase in the future, as developable land in downtown San Francisco becomes more scarce and expensive, it clearly suggests that it could take at least most of this century for the City to fully experience the opportunity cost of this proposed re-zoning.

The market value of property in the city would be lower by $5.9 billion as a result of the re-zoning of the industrial lands, according to the OEA's modeling. Assessed property valuation, which affects property taxes, is generally significantly less than property values, because under Prop. 13 property can only be re-assessed at market value when it is sold. Nevertheless, to put this number into perspective, the City's net assessed value is currently approximately $130 billion, and has been increasing at 6% per year for the past 15 years. This means that, in terms of assessed value, the lost growth associated with the plans will be less than one year's growth of city-wide assessed valuation and property tax. The estimated change in property values in the non-industrial areas of the Eastern Neighborhoods would be positive, but by a considerably smaller amount.

The proposed re-zoning would create significantly more housing—both market-rate and affordable—than would occur under a realistic application of current zoning controls. At build-out of the former industrial areas, the OEA estimates nearly an additional 8,000 housing units, and nearly 2,600 affordable units, would be constructed.

The re-zoning will also likely help to preserve the city's base of PDR jobs. At build-out under the current zoning, essentially no PDR space would remain, since PDR can afford to pay less for land than other uses. We estimate that over 14,000 PDR jobs would remain, under the present zoning, at current employment densities. Another 1,270 jobs would remain in so-called "Integrated PDR", a newly-recognized, more knowledge-oriented type of PDR activity in which most of the jobs would actually be office jobs.

However, the PDR and integrated PDR jobs preserved will not nearly make up for the office jobs lost—even when specific occupations are considered. An examination of the occupational staffing patterns of office-using industries like Business Services, Information, and Financial Services reveals that more jobs will be lost—in almost every major occupation—by the loss of 116,000 office jobs, than will be saved by the retention of 14,000 PDR jobs. Policymakers should consider if the conservation of these PDR/I-PDR jobs is worth the loss of a far greater number of office jobs, and whether the City's economic goals can be better met by imposing conditions on, rather than simply prohibiting, office development in the PDR zones in particular.

In addition, the area plans will establish new impact fees on residential and commercial development to pay for public improvements in the Eastern Neighborhoods. Given the current state of the real estate market in San Francisco, these fees will affect the financial feasibility of some projects, and delay the overall pace of construction.

Construction delays will postpone the incremental property tax revenue that the City will receive from new development. The OEA estimates that any more than a 1-year delay in development will cost more in property taxes than is generated in fee revenue, for a typical project.

This could create a negative fiscal impact on the City, and other recipients of property tax revenue, such as San Francisco Unified School District and BART. Policymakers should assess whether it would better to prioritize public improvements in the Eastern Neighborhoods, and simply appropriate future tax revenue for that purpose.

Highlights

- The economic impact of the legislation can be estimated by modeling what the market would build under the current and proposed zoning, and comparing the difference at complete build-out. It is important to consider that this build-out process would take many decades to actually occur. In addition, the build-out analysis only considered the former industrial areas, not the entire Eastern Neighborhoods. However, the vast majority of the change in property value will occur in those industrial areas.
- The greatest difference between a build-out at the current and proposed zoning is the amount of office space that would be built. At build-out, 29 million less square feet of office space would be built under the proposed zoning, than under the current zoning. This amount of office space could hold 116,000 jobs.
- Under the current zoning, essentially no Production, Distribution, or Repair (PDR) jobs would remain. Under the proposed re-zoning, over 14,000 PDR jobs would remain.
- Significantly greater amounts of both market-rate and affordable housing would be constructed under the proposed re-zoning, compared with a reasonable assessment of what would be permitted under the current zoning.
- The OEA's best estimates of current housing market conditions suggest that the new impact fees and enhanced inclusionary requirements could delay now-feasible development projects by two to four years.
- A sensitivity analysis suggests that project delays exceeding one year will cost the City more in lost property tax, than it receives in new fee revenue.

Risk Mitigation

- The primary risk to the City's economy from the Eastern Neighborhoods plan is the loss of new office space, which will be permanently prohibited in the PDR zones, and heavily restricted in most of the Mixed Use zones.
- Rather than simply permanently restricting new office uses in the Eastern Neighborhoods, the City could regulate new office development to ensure that new job opportunities are matched to the employment needs of San Francisco residents.
- Such an approach would slow down permitted office growth in the Eastern Neighborhoods—which is not likely to proceed rapidly in any event, based on past trends—and preserve PDR businesses in the short term better than the existing zoning. It would also ensure that the office development that will occur would support the City's economic goals of maximizing quality job opportunities for residents of every educational level.
- Alternatively, the City could increase the amount of office development permitted elsewhere in San Francisco to offset what is lost in the Eastern Neighborhoods.
- The impact of fees on development feasibility can be mitigated, going forward, by indexing them to the lower of either the OFHEO[1] Housing Price Index for San Francisco, or the Construction Cost Index. At present, only construction costs are considered.

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[1] The Office of Federal Housing Enterprise Oversight (OFHEO) produces this index. Since July of this year, it has been part of the new Federal Housing Finance Agency (FHFA).

ECONOMIC SCORECARD: PROPOSED LEGISLATION VERSUS CURRENT ZONING AT BUILD-OUT

The table below indicates the anticipated future change in San Francisco's economy resulting from the Eastern Neighborhoods Plan, compared to current zoning in the area.

It should be remembered that this build-out will take several decades at least, and that the area will receive a significant amount of development under the proposed zoning, compared to current conditions.

	Highly Negative Impact	Moderately Negative Impact	Neutral Impact	Moderately Positive Impact	Highly Positive Impact
Office Employment	■				
PDR Employment					■
Housing Supply				■	
Property Values		■			

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INTRODUCTION

Background

The Eastern Neighborhoods, consisting of the eastern half of South of Market (East SoMa), the Mission, Showplace Square/Potrero Hill, and the Central Waterfront, were once a core part of San Francisco's industrial economy. When the city began to lose industrial jobs in the 1950s, planning intended for a gradual conversion of industrial land to other uses, meant to keep pace with the changing San Francisco economy.

The economic growth of the 1990s, however, created two major shocks to the logic of the old zoning. First, the City saw a rapid increase in office development in the late 1990s. In particular, this development was spurred by internet and multimedia companies that were attracted to the lower rents in industrial areas, and did not require a traditional downtown location.

Second, the increased demand for high-end housing led to a boom in market-rate residential development in the Eastern Neighborhoods, including in live-work spaces which were not occupied by artists.

In other words, both office and residential development was attracted to the heart of San Francisco's industrial areas. These changes led to growing concern that office and residential development were pushing out PDR businesses that provide relatively high-wage job opportunities, especially for workers lacking English skills and four-year degrees. Additionally, concern grew for what was increasingly seen as haphazard development that would leave poorly planned neighborhoods ripe for land use conflict.

Recognizing this problem, the City implemented an interim zoning plan and began a community based appraisal of the Eastern Neighborhoods. The area plans analyzed in this report were created from this planning process. As detailed in the sections that follow, they involve a major re-zoning of the old industrial lands, to increase housing production and protect PDR businesses. They also introduce new development impact fees in the Eastern Neighborhoods. Both of these policy changes will have significant economic and fiscal impacts, as detailed in this report.

ECONOMIC IMPACT FACTORS

Introduction

The Eastern Neighborhoods plans will affect San Francisco's economy in two main ways.

First, over the long run, the re-zoning of the four areas will significantly change how San Francisco's economy will evolve over much of the rest of the 21st century.

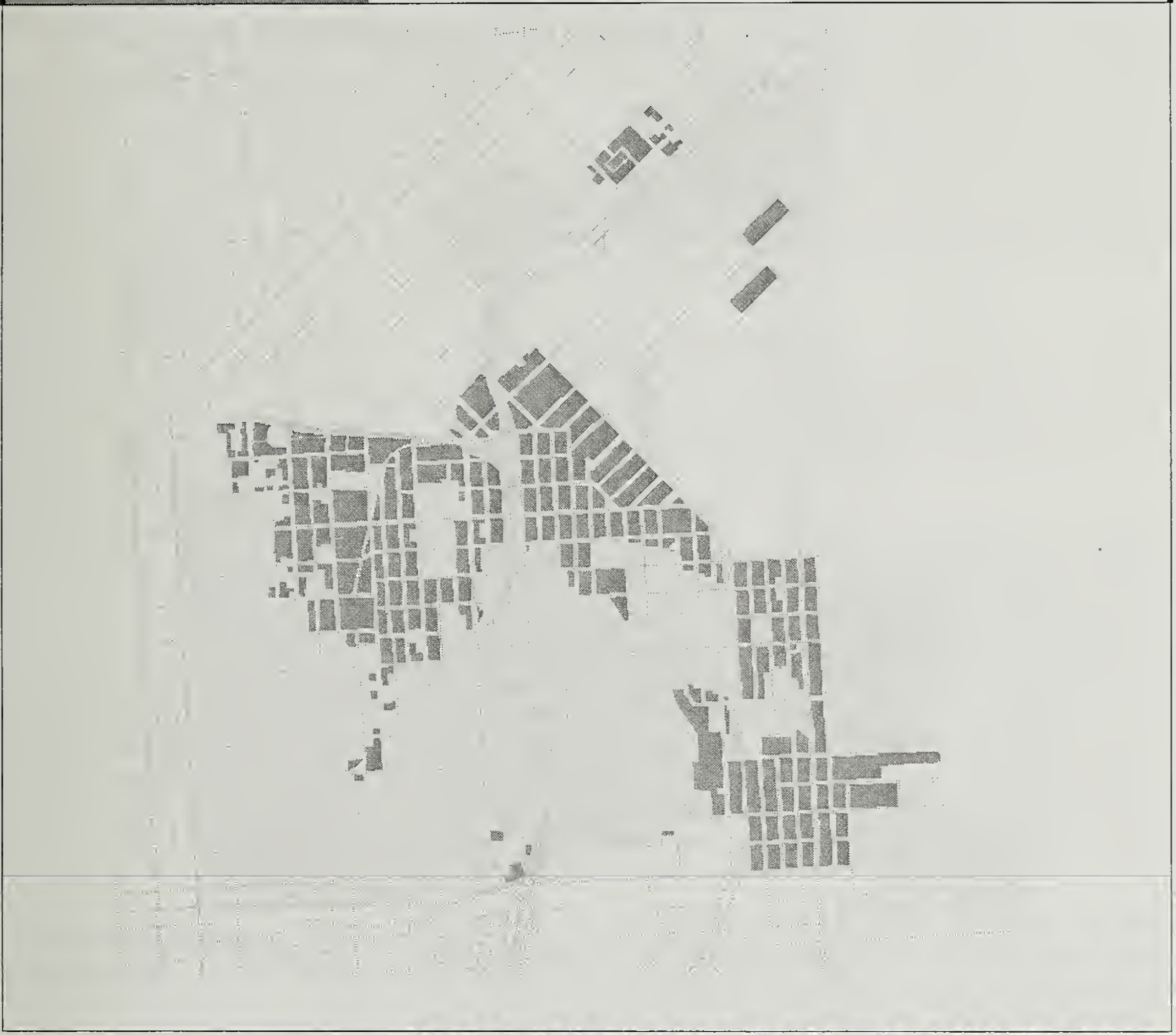
From an economic impact point of view, it is useful to divide the land in the Eastern Neighborhoods into two types, as shown in Figure 1 below. The land shown in green (or light gray in black and white) below is zoned for residential, neighborhood commercial, and public/institutional uses. Most of the land in the Mission and Potrero Hill, which are stable residential neighborhoods, falls into this category. The economic impact of the rezoning planned for these areas is fairly minor, as a whole and from a city-wide point of view. The analysis in the remainder of this section therefore does not consider the impact of the re-zoning in these areas.

The areas shown in blue, or dark gray in black-and-white, represents most of the industrially-zoned land in the Eastern Neighborhoods. This represents approximately 425 acres of land which are being rezoned from industrial to mixed use or PDR. While industrial activities have been permitted in these areas, office development has been permitted as of right, and housing development has been permitted with a conditional use authorization from the Planning Commission.

The industrial lands in the Eastern Neighborhoods have been critical employment lands for almost all of San Francisco's history. One of the most basic effects of the new proposed zoning will be to convert a large portion of this land from employment to housing uses, by reducing the permissibility of office development and easing restrictions on housing. Most of the rest of this land will be converted from a wide set of employment opportunities, to a much more restrictive set of so-called Production, Distribution, and Repair uses. The ultimate effect of this zoning will be to significantly reduce the land's ability to generate employment opportunities for residents of San Francisco and the Bay Area.

FIGURE 1

Industrial Lands Rezoned to Mixed Use or PDR in the Proposed Eastern Neighborhoods Plans



Second, in the short run, the fees charged to developers will affect the extent and pace of new development, and the level of investment in the city's neighborhoods. Higher fees will make some potential development projects financially infeasible, delaying construction. Given the current decline in housing prices in San Francisco, and the tendency for housing recessions to take several years to recover, fees that inhibit construction may prevent construction, and cost the City the property tax increment, for some time.

On the other hand, the funds raised from the fees is slated for needed investments in the community infrastructure throughout the Eastern Neighborhoods, including in open space, libraries, child care, and public protection. These investments will support community and economic development and, in time, improve the economic prospects of the residents of these neighborhoods.

The key fiscal impact question considered in this report is not the nature and extent of the need, but rather than strategy for securing the funding.

IMPACT OF REZONING INDUSTRIAL LANDS

Existing Zoning in the Industrial Lands

The current zoning of industrial lands in the Eastern Neighborhoods was intended to segregate industrial activities from other land uses that would be adversely affected by proximity to their noise and pollution. At the same time, it was recognized even then that San Francisco was entering a post-industrial economy and the demand for industrial space would decline in the future. At the same time, the demand for office space and housing would increase, and the zoning should accommodate this gradual transition.

As such, office development has been a permitted use in the Eastern Neighborhoods, at the fairly high density, in the M-1 and M-2 zones, of a 5.0 floor-area ratio (FAR)[2]. In the C-M (heavy commercial) zones, office development is permitted with an FAR of 9.0.

Housing is currently permitted with a conditional use from the Planning Commission. Housing density is also regulated, by the number of units allowed per square foot of lot area. In general, the permitted housing density for a parcel in the industrial lands is determined by the density in the nearest residential (R) zone. Other regulations concerning its development as a Planned Unit Development can increase the allowable residential density even further. Hence, even though residential density restrictions are generally lifted under the proposed zoning, the existing density limits imposed under the current zoning are, in many cases, quite high.

The New Zoning Proposals

As stated in the introduction, a major impetus to the development of the Eastern Neighborhoods area plans was the failure of the existing industrial zoning to produce a gradual change of land uses during the 1990s. Particularly during the dot-com boom of the late 1990s, the willingness of office uses and residents to locate within core industrial areas, led to conflicts between uses, rising rents, and displacement of businesses and low-income residents.

The proposed new zoning contains the following new types of zones:

- The *mixed use zones*: urban mixed use (UMU), mixed-use general (MUG), mixed-use office (MUR), and mixed-use office (MUO). In general, these zones are designed to encourage a mix of housing and other activities, and are permissive of both PDR activities and some degree of office space in conjunction with both housing and/or PDR. Office space is allowed on a specified number of floors of office-residential mixed use developments, or office-PDR mixed use developments. The number of floors of permitted office space depends upon the height of the building. However, office development alone is only permitted in the MUO zones, which represent a fairly small area within East SoMA. None of the former M-1, M-2, or C-M zones that are modeled in this section are proposed to be rezoned as MUG; most would become UMU, and a few MUO or MUR.

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[2] A floor-area ratio is a measure of the density of a building, defined as the total floor area of the building(s) on a site to its lot area. An FAR of 5.0 is essentially equivalent to a five-story building that uses the

- The *PDR zones* (PDR-1-G, and PDR-1-G) generally restrict all new housing and office development, except as noted below. The fundamental role of the PDR zones is to preserve employment in the production, distribution, and repair sector of the economy, under the theory that effectively subsidizing industrial rents by prohibiting other uses will reverse, or at least slow, the long-term decline in blue-collar employment in the city. As these industries are the primary source of quality jobs for San Franciscans without a college education, preserving these jobs will help preserve the social and economic diversity of the city.
- *Integrated PDR (I-PDR)* is a new land use concept intended to reflect the importance of design, marketing, R&D, and other non-fabrication activities in many contemporary manufacturing companies. Essentially, I-PDR is a land use in which 1/3 of the space is devoted to manufacturing, fabrication, and other activities similar to conventional PDR[3], and 2/3 of the space is non-PDR, particularly office. The I-PDR designation applies to buildings of two types:
    - New buildings in any PDR or mixed use zone.
    - Existing buildings in any PDR or mixed use zone, which were constructed prior to 1951 and have at least three stories.

  To some extent, the allowance of I-PDR uses within the PDR zones represents a liberalization of the prohibition against office space in those zones, as two-thirds of any I-PDR building may be office space. However, each individual company within an I-PDR building is required to maintain the 2/3-1/3 division of space. This prevents a building manager from, for example, renting four floors of a building to office-using software companies, and two floors to printing companies in the PDR sector. In an I-PDR building,

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[3] The definition of acceptable industrial uses in I-PDR is somewhat broader than in conventional PDR; it includes testing, for example.

[4] Estimation provided by the Planning Department.

- *Office legitimization*--there is an estimated 3.3. million square feet of office space in areas of the Eastern Neighborhoods[4] that is in proposed PDR areas where new office development would be prohibited. Much, if not most, of this office space is legally permitted, and would be a legal non-conforming use under the new zoning. Some buildings, however, were permitted under the old zoning, but do not have the proper permitting to operate as legal office uses under the new zoning. A legitimization process has been established to permit these offices to acquire the appropriate permits, for a fee, and become permitted under the new zoning. To some extent, this liberalizes the prohibition against office space within the PDR zones.
- *Life Science and Medical Special Use District*, and *Innovative Industries Special Use District*, are two zones within PDR zones which are intended for the development of new industries. In the Life Science and Medical Special Use District, which consists of several parcels around Mission Bay, medical and other laboratories are permitted, to foster the development of the biotech industry. In the Innovative Industries SUD, all office uses are permitted. However, this district only consists of the American Industrial Center on 3rd Street.
- *Small Enterprise Workforce (SEW)* is a land use that is permissive of any activity, other than residential, in PDR zones. The limitation of SEW uses is that the total square footage of any business cannot exceed 500 square feet, which is roughly equivalent to a 1-2 person business. The intention of this land use is to encourage the incubation of new small businesses within San Francisco, and it is modeled on a private developer who has successfully developed space for this purpose already. At present, however, San Francisco already has 70,000 self-employed individuals who effectively operate 1-2 person sole proprietorships or partnerships without any special land use designation. For this reason, it is unlikely that the SEW land use will become a major factor in the San Francisco economy, and it is not modeled as a land use in the analysis that follows.

Affordable Housing Requirements

Two of the major changes associated with the re-zoning in the Mixed Use zones are:

- Removing existing housing density limitations, and an increase in the allowable height of development in many sites
- Restricting office development, which reduces the competition from a major competing land use and should reduce the cost of land in these zones.

Both of these new regulations create value for housing developers, by first increasing the value of any given site, and secondly by using zoning to suppress land prices and hence the cost of development.

In exchange for this creation of new value, the plans attempt to maximize the production of affordable housing by increasing the inclusionary housing requirement in proportion to the value created. Thus, if the height increase of a particular parcel is 3 or more stories, the inclusionary requirement rises from the standard city requirement of 20% affordable, to a 27% affordability requirement. In effect, the plans are using an increased density, and hence profit, for market-rate housing to pay for an increased subsidy for affordable housing. The impact of these higher affordability requirements will be assessed in the next section.

Modeling the Economic Impact of the Rezoning

In the short run, the economic impact of re-zoning the industrial lands of the Eastern Neighborhoods will be imperceptible. Space for the expansion of office and housing requirements exists elsewhere in the city, regardless of the restrictions imposed by the new Eastern Neighborhoods zoning. Even under the current permissive zoning, there are many sites with little redevelopment pressure, and, absent another dot-com boom, land conversion would likely occur gradually for several years into the future.

Over the long term, however, San Francisco could be a very different economy and city because of these area plans. The proposed changes to the planning code will be permanent, and cannot be loosened by the actions of any future Planning Commission, only by amending the code again.

Thus, the best way to quantify this difference is to simulate a "build-out" of the industrial lands, under the current permissive zoning, and the more restrictive zoning proposed in the Eastern Neighborhoods area plans. Simulating a build-out means to assign each piece of land in the neighborhoods to their "highest-and-best use", i.e. what the market would build, under today's construction costs and prices for completed real estate. By comparing the two sets of zoning at build-out, we can observe how much of what types of space will be built, estimate what the gross property value of the area will be, estimate property tax differences, and estimate the differences in employment and population.

It must be kept in mind that this modeling exercise has an extremely long-run time horizon. There is, for example, approximately 32 million square feet of office space that could be built in the Eastern Neighborhoods, at some point in the future, under the current zoning. This is about half of the total office space now occupied in downtown San Francisco. It would likely take much of the rest of this century for the local market to develop and absorb this additional amount of space. Nevertheless, in time, the changes in zoning will affect both San Francisco's ability to develop its economy, and the overall geography of housing, employment, and transportation within the Bay Area.

Modeling Details

To estimate the economic impact of the re-zoning, the Office of Economic Analysis created a series of real estate pro formas for eleven different types of potential development across the Eastern Neighborhoods:

Current Zoning:

- Residential development, under the old density limits, and current citywide inclusionary housing requirements.
- Office developments alone, under the old density limits.
- Laboratory space.
- Existing PDR.

Proposed Zoning:

- Residential development, under the new zoning and new inclusionary housing requirements, which differ based on the size of the height increase received by each parcel.
- Office developments alone, under the new density allowances.
- Residential-office mixed-use developments, under the fees and inclusionary housing requirements.
- Office-PDR mixed-use developments, under new commercial development fees.
- Laboratory space, under the new zoning, including the Life Science and Medical SUD.
- New Integrated PDR (I-PDR) space.
- Existing buildings which are eligible for conversion to I-PDR.
- Existing PDR buildings. As a baseline, all parcels in the

industrial lands were assumed to currently consist of developed PDR space currently generating industrial rents.

These pro formas used current realistic market information, and the relevant regulatory parameters concerning allowable use, density, height, fees, and inclusionary housing requirements. Complete details of the assumptions used in this pro forma analysis are contained in Appendix A at the end of this report.

This analysis also used GIS-based information on the size and current and proposed zoning of all of the blocks and lots in the Eastern Neighborhoods. This set of areas was reduced to consider only those currently zoned industrial lands (M-1, M-2, and C-M) which were re-zoned to a mixed use or PDR zone. This represents approximately 1,115 parcels comprising about 425 acres in the Eastern Neighborhoods.

The economic impact of built-out under the current zoning was estimated by using the pro forma information to estimate a *land residual*, for each block, under each development alternative. The land residual represents the maximum amount a developer would pay for the land under a given use. In principle, a land owner would sell to the developer offering the highest bid, and the land would be redeveloped with the use offering the highest residual.

In other words, under the existing zoning, a land residual was calculated for a residential development, office development, laboratory development, and existing PDR use. The first three alternatives offer higher revenues but also involve site preparation and other development costs. Existing PDR uses generate less income, but do not require new development costs.

Of course, not every piece of land is currently being used for PDR, but this is not critical. This analysis intended to assess the different use of land at build-out under the two zoning scenarios, not to compare a build-out with an estimate of current use.

Similarly, estimating the build-out under the proposed zoning involved first determining which types of development are allowed in each block, and then estimating a land residual for each of the eight development possible development options listed above. The land was assigned to the use offering the highest land residual.

The total direct economic impact of the re-zoning, therefore, is the different land uses that occur at build-out under the current and proposed zoning.

Finally, the analysis recognizes that not every piece of land in the Eastern Neighborhoods will develop under one of the development alternatives listed above. Even in downtown, for example, approximately 20% of the land is neither office nor residential, but retail, public, institutional, and other resident- and worker-supporting uses.

This same percentage was deducted from these two build-out simulations of development in the Eastern Neighborhoods. This percentage is a rough estimate, but since it applies to both build-out scenarios--current and proposed zoning--it does not affect their economic impact, relative to one another.

Results of the Build-Out Analysis

The results of the two build-out scenarios are summarized in Table 1 below. Because housing requires a conditional use from the Planning Commission under the current zoning, there is no certainty regarding how much housing would be built under this zoning in the future. Moreover, because housing is generally the highest-and-best use in most areas of the city, uncertainty regarding housing affects the overall future land use to a great extent. For this reason, the current-zoning simulation gave each block a 50% chance of being approved for housing.

TABLE 1

Results of the Build-Out Analysis: Current and Proposed Eastern Neighborhoods Zoning

	Current Zoning - 50% housing approved	Proposed Zoning	Difference
Housing			
Total Number of Housing Units	12,925	20,880	7,955
Number of BMR Housing Units	2,749	5,337	2,588
Population	22,877	36,957	14,081
Office			
Square Feet of Office Space	32,619,323	3,569,912	-29,049,411
Office Jobs	130,477	14,280	-116,198
PDR			
Square Feet of PDR	0	4,605,726	4,605,726
Square Feet of IPDR	N/A	356,077	356,077
Estimated PDR jobs	0	13,507	13,507
Estimated IPDR jobs	0	1,270	1,270
Fiscal			
Property Value	$ 23,304,830,761	$17,432,588,352	-$5,872,242,409

Key conclusions emerging from the analysis include:

- Under the current zoning, housing is almost always the highest use, except in unusual circumstances where the nearest residential zone is low-density, and the allowable office density is relatively high. The same holds for the new zoning; housing is almost always the highest and best use, even with the new fees and the expanded inclusionary requirements.

- The amount of housing will be significantly higher, in the new zoning, vs. the admittedly arbitrary case of a current-zoning build-out scenario where 50% of sites are allowed to build housing. In particular, it is notable that the percentage of below-market-rate (BMR) housing units is significantly higher under the new zoning, rising to about 25% from 15%.
- The far greater impact is on office development and office employment. For the 50% of cases where housing is assumed not to receive a conditional use, under the current zoning, office development is the highest use. Because office development is so heavily restricted in the proposed zoning, the loss of office space is the most pronounced change between the two zoning approaches. At build-out, there would be 32 million fewer square feet of office space. At prevailing job densities, this space could hold 116,000 fewer jobs at build-out than would develop in these areas under the current zoning.
- The 3.5 million square feet of office projected at build out under the proposed zoning includes the estimated 3.3 million square feet that would either be a legal non-conforming use under the new zoning, or eligible for legitimization.
- Under build-out under the current zoning, no PDR space would be left in the study area. Because I-PDR is not a concept used in the current zoning, no I-PDR would also be developed in the area.
- In the propose zoning, 4.6 million square feet of PDR space would remain, all in the PDR zones. At current estimated job densities, this would preserve approximately 14,000 PDR jobs. This estimate assumes that establishing the PDR zones will prevent the further loss of PDR jobs, and that employment density does not decline in the future.
- 356 thousand square feet of I-PDR would be created under the proposed zoning. All of this would be existing buildings converted for I-PDR use; no new I-PDR development would occur. This is because it is more profitable to maintain existing PDR uses than demolish and rebuild new I-PDR
- The net loss of approximately 102,000 jobs is equivalent to 15%-20% of the entire base of private wage-and-salary jobs in San Francisco at the present.
- In the proposed zoning, life science laboratory space

generates a lower residual than housing in the urban mixed use zones, and lower than existing PDR in PDR zones. For this reason, no laboratory space is projected for development. Again, existing PDR is assumed to generate a city-wide average industrial rent, at a typical PDR density[5].

- Total property value at build-out would decline by approximately $5.9 billion under the proposed zoning.

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[5] Density is 0.62 square feet of PDR space per square foot of lot area. Source: Economic & Planning Systems, *Supply/Demand Study for Production, Distribution and Repair (PDR) in San Francisco's Eastern Neighborhoods.*

OCCUPATIONAL ANALYSIS OF JOB CHANGES

Existing Zoning in the Industrial Lands

As discussed in the previous section, the net loss of 116,000 office jobs at build-out would greatly exceed the approximately 14,000 PDR jobs gained by the creation of the PDR-only zones.

The essential reason for this difference in job losses vs. retention is density. PDR buildings use space much less intensively than office buildings, and offices generally devote less square footage of constructed space per employee than industrial buildings[6].

Nevertheless, the central rationale for the PDR zones is not the raw number of jobs, but their importance to the city's labor market. San Francisco's economic and social diversity has been declining for several years, partially because the city has only generated new jobs at the very high-end, and low-end, of the labor market. Most jobs in the PDR sector are an exception to this; they are the only industry where the majority of jobs provide above-average salaries to workers who lack a four-year college degree. If this sector could be expanded, or at least preserved, it is argued, the city could better restore balance in its job market, and its population.

To our knowledge, no analysis has been done that systematically looks at the types of jobs created by retained PDR vs. lost office jobs in the Eastern Neighborhoods. However, the state Employment Development Department does publish Occupational Staffing Patterns by industry. This database analyzes the specific types of occupations that different industries create as they grow. The OEA created a profile of the PDR sector, and the Office sector[7], and then analyzed these occupational staffing patterns to illustrate the types of jobs created by the expansion of each sector of the economy. These sector-wide staffing patterns are shown in the first two numeric columns of Table 2.

They show, not surprisingly, that office industries have a much greater reliance on business, financial, computer, and design occupations, while the PDR industries have a much greater reliance on construction/extraction, production, and materials moving occupations. However, the differences are not as stark as one might think: only 55% of the PDR workforce is in the traditional "blue collar" occupations of construction/extraction, manufacturing, or transportation. Nearly 20% of the PDR workforce works in office and administrative support, for example.

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[6] For example, the EPS report referred to earlier identified 9.4 million square feet of occupied PDR space in the former industrial zones in 2004. Our analysis finds that the industrial lands studied in this section contain 18.6 million square feet of parcel land area. This suggests that there is about 0.5 square feet of occupied PDR space per square foot of parcel area in the former industrial areas. Incidentally, this effective PDR density is lower than the 0.62 ratio used in this report, also taken from the EPS study.

[7] For the purposes of this analysis, the PDR sector was defined as the construction, manufacturing, wholesale trade, and transportation sector. The Office sector was defined as the Information, Financial Activities, and Professional and Business Services Sector.

TABLE 2

Net Office Jobs Lost, and Net PDR Jobs Retained, Under the Proposed Zoning at Build-Out, Versus Current Zoning

Occupation	% of Office Industry Jobs	% of PDR industry jobs	Net Office Jobs Lost Under Proposed Zoning	Net PDR Jobs Preserved Under Proposed Zoning	Difference
Management	10%	9%	(11,158)	1,261	(9,897)
Business & Financial Operations	10%	3%	(11,867)	483	(11,384)
Computer & Mathematical	9%	3%	(10,213)	413	(9,800)
Architecture and Engineering	4%	5%	(5,031)	665	(4,365)
Life, Physical, & Social Sciences	2%	1%	(2,162)	100	(2,061)
Community & Social Services	0%	0%	(141)	0	(140)
Legal	3%	0%	(3,470)	6	(3,464)
Education, Training, & Library	0%	0%	(87)	1	(86)
Arts, Design, Entertainment	5%	1%	(5,968)	92	(5,876)
Healthcare Practioners	1%	0%	(1,573)	5	(1,568)
Healthcare Support	1%	0%	(642)	0	(642)
Protective Services	4%	0%	(4,671)	10	(4,661)
Food Preparation & Serving	0%	0%	(213)	17	(196)
Building & Grounds Clearing	5%	0%	(5,341)	7	(5,334)
Personal Care and Service	0%	1%	(454)	102	(352)
Sales and Related	8%	2%	(9,491)	276	(9,215)
Office & Administrative Support	29%	19%	(33,042)	2,764	(30,278)
Farming, Fishing, Forestry	0%	0%	-	31	31
Construction and Extraction	1%	24%	(1,081)	3,602	2,521
Installation, Maintenance, and Repair	2%	3%	(2,520)	386	(2,133)
Production Occupations	3%	16%	(3,413)	2,282	(1,131)
Transportation & Material Moving	2%	15%	(2,707)	2,209	(498)
Total	100%	100%	(115,245)	14,714	(100,531)

Source: California Department of Employment Development; U.S. Bureau of Labor Statistics

This analysis becomes particularly important in the context of the relative job losses associated with the Eastern Neighborhoods re-zoning. The next two columns multiply the projected office job loss, and PDR job retention, by the occupational staffing percentages, to get a net job creation/retention *by occupation.*

The results are very significant. The fundamental point is that *the loss of office jobs leads to a net loss in almost every major occupational category*: even production and transportation/material moving occupations.

DEVELOPMENT IMPACT FEES AND INCLUSIONARY HOUSING REQUIREMENTS

Background

The Eastern Neighborhoods Plans include a provision for the collection of development impact fees to fund a variety of public improvements[8]. In addition, the Eastern Neighborhoods Plan requires a greater inclusionary housing requirement, compared to existing city policy[9]. This section estimates the economic and fiscal impacts associated with the proposed Eastern Neighborhoods development impact fees, and inclusionary housing requirements.

Imposing the proposed Eastern Neighborhoods development impact fees, and the more robust inclusionary requirements will increase development costs. This could potentially affect development feasibility in the Eastern Neighborhoods. This in turn could delay the pace of development, affecting property tax and other revenues collected by the City.

Accordingly, the issues analyzed in this section include:

1. The impact of increased costs on development feasibility, and the pace of development, and
2. The subsequent impact on property tax revenue.

Summary of Proposed Fees and Uses of Funds

The proposed Eastern Neighborhoods development impact fees will fund public improvements to the following four components of neighborhood-serving infrastructure required to accommodate Plan build-out:

- **Library** - to purchase new library materials and fund renovations and expansions.
- **Transportation** – to undertake circulation improvements needed to accommodate increased traffic flow and pedestrian and bicycle movements and to increase the capacity of public transit.
- **Recreation and Parks** - to purchase additional parkland and upgrade existing recreation and parks facilities to serve new development.

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[8] See Planning Department Case Implementation Report, April 10, 2008, for full explanation of the proposed development impact fees and inclusionary requirements at: http://www.sfgov.org/site/uploadedfiles/planning/Citywide/Eastern_Neighborhoods/EN_BOS_Vol4_ImplementationPart6_Web.pdf

[9] Inclusionary housing fees can be paid in-lieu of providing units within the project. Currently the Citywide option is to provide 15% affordable units on-site or 20% off-site. In-lieu of providing units off-site, a developer can opt to pay in inclusionary fee, based on the number of off-site units required (i.e., 20%). The proposed Eastern Neighborhoods off-site inclusionary fees would increase from 20% to 23% to 27%, depending on the site. This analysis assumes payment of the inclusionary fee, rather than providing affordable units on-site.

- **Child Care** - to provide new spaces to care for the children of new residents and workers.

The proposed EN Fees range from $8 to $16 per gross square foot for residential development and $16 to $24 per gross square foot for non-residential projects, as summarized in the below table.[10]

TABLE 3

Proposed Eastern Neighborhoods Impact Fees and Inclusionary Requirements

	Tier	Description	Previous Zoning Districts	Resid Fee*	Comm Fee**	Inclusionary requirement	Alternatives		
							Middle Income	Land Dedication	
Existing Residential/ Comm. Zones	1	Projects without height increase	SLR, MUR SSO, NC, RM	$8	$16	15% onsite 20% offsite	x	x	Focused towards improved neighborhoods
	2	Projects with 1-2 story height increase	SLR, SSO, NC, RM	$12	$20	15% onsite 20% offsite	x	x	
	3	Projects with 3+ height increase,	SLR, MUR SSO, NC, RM	$16	$24	15% onsite 20% offsite	x	x	
Formerly Industrial Zones	A	UMU/Projects without height increase	M1, M2, CM	$8	$16	18% onsite 23% offsite	30-40%	35%	Focused towards expanding affordability
	B	UMU/Projects with 1-2 story hgt increase	M1, M2, CM	$8	$20	20% onsite 25% offsite	40-50%	40%	
	C	UMU/Projects with 3+ hgt increase; other designated districts	M1, M2, CM	$8	$24	22% onsite 27% offsite	50-60%	50%	

** Fees are in gross square foot ($8/gsf=$10/nsf, etc)*

*** Fees will be reduced where duplication occurs: most commercial fees will be reduced by $10 per gsf per TIDF.*

**** Range for middle income represents 2 bedroom requirement, i.e 30% if project meets min 2 bedroom requirement; 40% if project provides all micro units.*

Impact fees vary depending on the current zoning and the height increases resulting from rezoning. Residential projects with no height increase or located within former industrial zones will be assessed the minimum $8 per sq. ft. fee, while projects adding 3 or more floors will be assessed a $16 per sq. ft. fee. The table also summarizes the proposed inclusionary housing requirement for each tier, which increases the number of units set aside as affordable from 20% to up to 27%, depending on tier.

The fee revenue will be allocated to each component based on the following distribution[11].

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[10] Commercial fees will be reduced where duplication occurs. Specifically, commercial fees will be reduced by $10 to account for duplicate transit fees already imposed on non-residential development ($10 citywide transit impact development fee (TIDF)).

[11] The allocation is based on the relative maximum fee of each component derived in the Eastern Neighborhood nexus study.

TABLE 4 **Proposed Eastern Neighborhood Impact Fees – Allocation of Fee Revenue by Component**

Component	Residential	Commercial
Open Space and Rec Facilities	50%	7%
Transit, streetscape, public realm improvements	42%	90%
Child care and Library	8%	3%

Source: Planning Department's April 17, 2008, Eastern Neighborhoods Initiation Package, page1207.

The Planning Department estimates that Eastern Neighborhoods impact fee revenue will cover between 30% and 50% of the estimated $245 to $395 million Eastern Neighborhoods public improvements[12].

Impact on Development Cost and Feasibility

To illustrate the potential fiscal and economic impacts of these fees, the OEA developed a series of residential development pro formas, for a hypothetical parcel in a C-M district in the Eastern Neighborhoods. This parcel is assumed to currently contain an operating industrial use, and is proposed to change to Urban Mixed Use (UMU) zoning. The pro formas were created to study the effect of the new fees on a landowner's decision to change uses from industrial to residential use, as allowed by the UMU zoning.

Even without the new fees and inclusionary requirements, the hypothetical housing project analyzed is only marginally feasible, given current market conditions.[13] When the proposed impact fees and inclusionary requirements are included as additional development costs, financial feasibility is diminished.

Since the project prototype studied is currently on the margin of the standard market threshold return needed to proceed, the decrease in return, if all else remains constant, could negatively affect decisions about projects proceeding. In other words, imposition of the development impact fees and inclusionary requirements would have an adverse effect on residential development at this time, given current market conditions.

However, market conditions are cyclical, and what is not feasible today may be in the future, with the right combination of increased sales values and/or reduced construction costs. Under less stressful economic conditions, development projects could absorb some of the increased Eastern Neighborhoods costs with increases in sales prices or rent levels. The difficulty with current market conditions is that sales prices are not increasing and will likely continue to decrease in the near-term. In addition, there is no indication yet that there will be a corresponding decline in construction costs.

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[12] See Planning Department's April 17, 2008, Eastern Neighborhoods Initiation Package, pages 1217-1218. Based upon build out of Option B in the Draft Environmental Impact Report (DEIR). (7.385 housing units and approximately 2.5 million square feet of non-residential development). approximately $113 million in fee revenue is estimated.

[13] This conclusion is consistent with the results of a recently completed study commissioned by the Controller's Office to determine the impact of citywide development fees on financial feasibility. The 8/12/2008 Keyser Marston Associates (KMA) report, *Sensitivity Evaluation: Potential Citywide Development Impact Fees - Impact on Development Project Economics* can be found at: http://co.sfgov.org/webreports/details.aspx?id=744.

For these reasons, this analysis includes an estimate of the timing of the housing market recovery. When housing prices increase enough to restore feasibility, stalled developments will move forward. The OEA estimated the length of time required to restore feasibility under various scenarios. The range of results is then used to illustrate the impact of delay on fiscal revenues.

The first step in this analysis valuing the hypothetical site as occupied by existing industrial use. For purposes of this analysis, it is assumed that a 2-story, 40,000-square-foot industrial building is operating on the 25,000-square-foot parcel, at industrial market rents, as follows:

TABLE 5 Existing Hypothetical Industrial Building Valuation Estimate

	Per Sq.Ft.	Sq.Ft./Units	Total
Annual NNN Rent (NOI)	$10.26	40,000	$410,400
Cap Rate	8%		8%
Value of Existing Use	$128	40,000	**$ 5,130,000**
Value per Sq.Ft. of Lot Area	$205	25,000	
Value per Unit of Residential Development		76	**$ 67,500**

Note: Rental rate based on NAIBT NNN monthly rent of approximately $0.90 per sq.ft. for industrial product in San Francisco. Annual rent shown is net of 5% vacancy rate. Cap rate based on review of Korpacz (Price Waterhouse Coopers) Real Estate Investor Survey and RealtyRates.com investor survey for industrial properties. Value per residential unit assumes post-zoning change in density on the 25,000-square-foot lot.

Based on current industrial rents and capitalization rates in San Francisco, a value of $5.1 million is estimated for the 25,000 sq. ft. parcel.

This value represents the *minimum* price a landowner would accept for the property, as it reflects the value generated by existing uses. Assuming the property owner is not behaving strategically—by withholding the site in anticipation of more intensive zoning, for example—the owner could theoretically be motivated to sell at any price higher than the existing value.

Development Feasibility

There is a minimum rate of return at which point it is feasible to develop a site. This occurs when a new development project has the right combination of anticipated revenue and development costs to deliver a risk-adjusted rate of return acceptable to the developer/landowner.

A common measure to determine initial feasibility is return on cost, defined as net revenue divided by total development cost (including land). The minimum acceptable return on cost varies depending on product type, market, and individual developer, but generally falls within a range, which can be gleaned from the market. For low-rise residential development, the current acceptable range is estimated at 18 to 20% return on cost.[14]

The OEA ran a series of pro formas to calculate the return on cost (with a fixed land cost), under various scenarios. The resulting metrics can be compared to market conditions to determine general feasibility.

Development Pro Forma Scenarios

For the comparative pro forma analysis, several scenarios were analyzed:

- **Scenario 1** - assumes residential development under existing CM zoning, which allows for up to 76 units on 5 floors for this parcel, accounting for site coverage and setback requirements. The inclusionary requirement is set at the existing rate of 20% of units, and there is no Eastern Neighborhoods impact fee[15].
- **Scenario 2** – assumes rezoning from CM to UMU. No increase in density is assumed; the only difference is that the inclusionary requirement increases to 23%, with no Eastern Neighborhoods impact fee. This scenario gives an indication of the impact of increased inclusionary requirements on feasibility.
- **Scenario 3** – same as Scenario 2, but with the inclusion of Eastern Neighborhood impact fees. This scenario represents the proposed fees and inclusionary requirements under the Eastern Neighborhoods Plan.

Appendix B provides detailed assumptions used in the analysis, including development costs, finished values, density assumptions, unit sizes and mix, among others. For the illustrative pro forma analyses, it is assumed that the new zoning will not result in a height increase. Although some sites in the Eastern Neighborhoods will benefit from up-zoning, a majority of the sites in the study area will have either no height increase or a height decrease[16].

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[14] Source: 8/12/2008 Keyser Marston Associates (KMA) report, *Sensitivity Evaluation: Potential Citywide Development Impact Fees - Impact on Development Project Economics*: http://co.sfgov.org/webreports/details.aspx?id=744.

[15] Inclusionary housing fees can be paid in-lieu of providing units on-site. Fees are based on the number of units which a developer would be required to provide if the units are developed off-site. Currently the option is to provide 15% affordable units on-site or 20% off-site. This analysis assumes payment of the inclusionary fee, rather than providing affordable units on-site in all scenarios.

Pro Forma Results

A method to calculate feasibility when site acquisition costs are known is to solve for developer return and determine if it falls within an acceptable range, given the risk of the project. For purposes of this set of pro formas, the land acquisition cost is based on the value under the hypothetical site's existing industrial use, or $5.1 million, as calculated in Table 5. Since 76 housing units could be developed under both the old and new zoning, this land price works out to $67,500 per unit. Therefore, this per-unit land value is used the land acquisition cost and the developer return is calculated as shown below.

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[16] The OEA analyzed the change in building heights resulting from the rezoning of approximately 1,120 parcels in the formerly industrial zones (M1, M2, CM) and found that 52% of the parcels will have no height increase and 12% will have a height *decrease*, while 25% will have a 1 story height increase and 10% will have a 2 or more story height increase.

TABLE 6

Illustrative Residential Development Pro Formas - Eastern Neighborhoods – Solving for Developer Return at Existing Industrial Land Value

Scenario 1 - Existing Zoning, no impact fee, 20% inclusionary requirement

	Per Unit	Units	Total
Completed Property Value at Buildout	$690,000	76	$52,440,000
Demolition Cost (per sq.ft.)	($15)	40,000	($600,000)
Development Costs	($412,875)	76	($31,378,500)
Inclusionary Fee	($59,073)	76	($4,489,584)
Proposed Development Impact Fee	$0	76	$0
Sales Expenses	($24,150)	76	($1,835,400)
Residual Value for Land & Profit (Value - Cost)	$186,007		$14,136,516
Less Land Cost (at existing use value)	($67,500)	76	($5,130,000)
Developer Profit	$118,507		$9,006,516
Developer Return on Development Cost (profit/cost)			*20.7%*

Scenario 2 - New UMU Zoning, no impact fee, 23% inclusionary requirement

	Per Unit	# Units	Total
Completed Property Value at Buildout	$690,000	76	$52,440,000
Demolition Cost	($15)	40,000	($600,000)
Development Costs	($412,875)	76	($31,378,500)
Inclusionary Fee	($67,935)	76	($5,163,022)
Proposed Development Impact Fee	$0	76	$0
Sales Expenses	($24,150)	76	($1,835,400)
Residual Value for Land & Profit (Value - Cost)	$177,146		$13,463,078
Less Land Cost (at existing use value)	($67,500)	76	($5,130,000)
Developer Profit			$8,333,078
Developer Return on Development Cost (profit/cost)			*18.9%*

Scenario 3 - New UMU Zoning, impact fee, 23% inclusionary requirement

	Per Unit	# Units	Total
Completed Property Value at Buildout	$690,000	76	$52,440,000
Demolition Cost	($15)	40,000	($600,000)
Development Costs	($412,875)	76	($31,378,500)
Inclusionary Fee	($67,935)	76	($5,163,022)
Proposed Development Impact Fee	($8,518)	76	($647,341)
Sales Expenses	($24,150)	76	($1,835,400)
Residual Value for Land & Profit (Value - Cost)	$168,628		$12,815,737
Less Land Cost (at existing use value)	($67,500)	76	($5,130,000)
Developer Profit			$7,685,737
Developer Return on Development Cost (profit/cost)			*17.2%*

As indicated, with land acquisition at $67,500 per unit[17], residential development under both the existing C-M zoning and first rezoning scenario (without the Eastern Neighborhoods fees) provide returns that exceed the threshold rate, meaning the project is feasible and could move forward.

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[17] This value represents the minimum price the landowner would accept for the property, as it reflects the value generated by existing uses. This analysis assumes the property owner is not "land-banking" the site in anticipation of more intensive zoning (and presumably higher residual land values), and would be motivated to sell at any price higher than the existing value, or $67,500 per unit, as previously calculated. Underlying these scenarios is the simplifying assumption that land values will adjust to reflect the existing use, and that the existing landowner would be willing to sell at this price, rather than the potentially higher value resulting from site redevelopment at a higher and better use.

Under Scenario 3 (the option that reflects the proposed Eastern Neighborhoods rezoning with both increased inclusionary requirements and the new Eastern Neighborhoods fees), the return is below the threshold 18% rate, indicating that the project is not feasible and would likely not proceed until either costs came down or the finished unit sales prices increased. In effect, the proposed rezoning would render the project infeasible, even assuming a relatively low land acquisition price, delaying development until feasibility is restored. [18]

In other words, a developer would refuse to build housing a that rate of return, and a landowner would refuse to sell the land at a price that would make the project feasible for the developer.

Sales prices would have to increase about 1% (with no other costs increases) before a developer would be motivated to move forward with the project. This finished unit price increase would result in an 18% return on cost, the minimum threshold return rate assumed in this analysis.

Estimated Delay in Development Resulting from Increased Eastern Neighborhoods Costs

The analysis suggests that the economic and fiscal impact of fees is largely a question of timing. How long will it take for San Francisco's residential market to rebound, and housing prices to increase sufficiently to absorb the additional costs and restore feasibility?

Although the medium and long-term housing appreciation trends are positive, recent performance indicates prices are in decline locally. Predicting when this downward trend reverses itself is speculative at this time. However, recent events can offer insight as to the direction the market is heading.

To estimate when prices will recover, the OEA examined historic housing appreciation in the San Francisco metro division (San Francisco, Marin, and San Mateo counties), as reported by the Office of Federal Housing and Oversight (OFHEO). In addition, the OEA reviewed economic projections by Moody's Economy.com related to the timing of recovery in the nation's housing market[19].

Nationwide, housing values have declined an average of 20% since the peak in late 2006[20], while the San Francisco metro division has fared comparatively well with a 7% decline in prices during the same time-frame.[21] Moody's/Economy.com projects that housing prices will fall another 10% nationwide before price appreciation returns at the end of 2010.

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[18] The per-unit value used in this analysis is at the low end of recent residential land transactions in the Eastern Neighborhoods, which indicated a range of $70,000 to $120,000 per residential unit, depending on location. Source: 4/14/2008 Clifford Associates report, *Land Values in the Eastern Neighborhoods*, Table 4. A higher land acquisition cost would negatively impact the financial feasibility of the hypothetical project in this analysis.

[19] Source: Moody's Economy.com seminar, "When Will it End?," September 23, 2008.

[20] Source: Fiserv Case Shiller National Housing Price Index

The housing price decline experienced in the San Francisco Metro Division since the peak in late 2006 is about one-third the 20% housing depreciation experienced nationwide (7%/20%). Assuming prices fall another 10% nationwide, as projected by Moody's/Economy.com, and the relationship between the local market and national market remains, housing prices would be expected to decline another 3.5% locally before positive appreciation returns at the end of 2010.

The following presents a probable recovery scenario of housing prices, based on the above discussion. As indicated, prices are anticipated to decline in the upcoming year, level off in 2010, and begin increasing modestly in 2011 and 2012, and thereafter increasing at historic average appreciation rates.[22]

TABLE 7

Projected Annual and Cumulative San Francisco Housing Price Appreciation, 2009-2016

Year	Projected Annual Housing Appreciation	Projected Cumumlative Appreciation (1)
2009	-3.50%	-3.50%
2010	0.00%	-3.50%
2011	1.00%	-2.50%
2012	2.00%	-0.50%
2013	2.50%	2.00%
2014	2.50%	4.50%
2015	6.00%	10.50%
2016	6.00%	16.50%

Notes: (1) Cumulative housing price appreciation from the end of 2008.

Sources: Office of Federal Housing and Oversight (OFHEO) for the San Francisco metro division (San Francisco, Marin, and San Mateo counties) http://www.ofheo.gov/hpi_city.aspx

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[21] Source: Office of Federal Housing and Oversight (OFHEO) for the San Francisco metro division (San Francisco, Marin, and San Mateo counties).http://www.ofheo.gov/hpi_city.aspx

[22] Per OFHEO, annual housing price appreciation in the San Francisco Metro Division during the past 20 years averaged 6% per year. A more recent time period covering the past 3 years indicates prices appreciated an average of 2.5% per year. This level of appreciation is assumed for the interim years of 2013 and 2014, while the long-term average is used after 2014.

Estimated Delay in Development and Impact on Property Tax Revenues

The results of the previous section are used to illustrate the impact of development delay on property taxes and impact fee revenues.

As discussed above, in this example the OEA determined that, given the proposed fees and higher inclusionary requirements, it would take a minimum of two to four years for the project to become feasible again.

During this delay, the City would lose the incremental property tax revenue that it would receive when a higher-valued building replaced a lower valued one. It is important to realize that this property tax increment is not simply deferred, it is actually lost forever during the years of delay.

In general, the higher the fees and inclusionary requirements, the longer the potential delay, and the greater the loss of incremental property tax, even though the fee revenue and affordable housing will ultimately be greater.

Thus, there is a trade-off between higher fees and inclusionary requirements, and lower incremental property tax, and this trade-off depends on how long it takes real estate prices to grow to absorb the higher costs.

Table 8 below illustrates this point. Both scenarios (Existing Inclusionary/No Fee and Proposed Inclusionary with Fee) assume the existing industrial site is eventually redeveloped with a higher value use; the difference between scenarios is the fee and inclusionary requirements applied to the project. This higher cost burden results in a project delay for the Proposed Inclusionary with Fee scenario, which are shown as different rows of the table.

For example, if the project is delayed only one year because of the higher fees, the net fiscal impact will be positive, because relatively little incremental property tax revenue will be lost, but the City will recoup the higher fees and affordable housing.

On the other hand, if the project is delayed for more than one year, the incremental property tax lost is greater than the fees and affordable housing received.

The City and County of San Francisco does not receive all of the property tax revenue paid by San Francisco property owners. The San Francisco Unified School District, BART, the Bay Area Air Quality Management District, and City College of San Francisco, all receive portions of this tax payment.

To focus on the fiscal impact to just the City and County, the right columns of the table show just the incremental property tax revenue that would accrue to City funds, and how it would be affected by development delays. Again, any delay greater than one year would lead to a negative net fiscal impact.

As stated above, the OEA believes the most likely outcome is a 2-4 year delay, given current housing market conditions.

It is important to keep in mind that this illustration reflects only one hypothetical parcel. If the same methodology were applied across the entire Eastern Neighborhoods Plan area, the net result could be multiplied over hundreds of parcels (where no height increase results from the rezoning). While some parcels within the Plan area will benefit from height increases which could enhance feasibility and allow a project to absorb the increased costs, the majority of parcels do not benefit from a density bonus, but will still be subject to the increased fees and inclusionary requirements.

TABLE 8

Impact of Project Delay on Tax and Fee Revenue– Hypothetical Redevelopment Project

	Total Property Tax Revenue (3)			CCSF Property Tax Revenue Only (4)		
Development Delay (Years)	Existing Inclusionary, No Fees (1)	Proposed Inclusionary and Fee (2)	Difference	Existing Inclusionary, No Fees (1)	Proposed Inclusionary and Fee (2)	Difference
1	$1,092,263	$1,142,731	($50,468)	$820,071	$998,863	($178,792)
2	$1,600,419	$1,123,699	$476,720	$1,201,595	$975,356	$226,238
3	$2,065,368	$1,105,913	$959,455	$1,565,290	$954,119	$611,171
4	$2,546,604	$1,092,104	$1,454,500	$1,911,991	$934,969	$977,021

Note: This analysis presents the net present value of property taxes and Eastern Neighborhoods fee revenues collected by the City assuming a 1 to 4-year delay in development of a hypothetical parcel 25,000-square-foot parcel from an existing industrial use to residential use.

(1) Existing zoning assumes 20% inclusionary requirement and no impact fee revenue.

(2) Proposed zoning assumes 23% inclusionary requirement and $8/ SF impact fee revenue. In these scenarios, the site is assumed to operate and generate tax revenues at its current industrial use, until such time the market recovers and the site is developed with the higher and better use.

(3) Includes all property taxes collected by the City, accruing to all funds, including schools.

(4) Includes only property taxes accruing to City funds, excluding schools. In FY 07/08, approximately 75% of property tax revenue accrued to various City funds, including General Fund, Open Space Fund, Children's Fund, and Library Preservation fund, as well as bond overrides.

RISK MITIGATION

Economic Costs of Rezoning

The primary long-term risk to the City's economy from the Eastern Neighborhoods plan is the loss of the opportunity for new office development, which will be permanently prohibited in the PDR zones, and heavily restricted in most of the mixed use zones.

As described earlier, the City will not experience this cost as a loss of jobs, but rather as a lost opportunity to develop its employment base, which has grown significantly more slowly than other Bay Area counties since the 1960s.

Part of the motivation to restrict office development has been the perceived bad fit between the employment needs of the surrounding neighborhoods, and the types of jobs created by office employment. This analysis suggests, on the other hand, that the higher density of office employment would likely create more jobs, in almost every occupation, than PDR space.

Rather than simply permanently restricting new office uses in the Eastern Neighborhoods, the City could regulate new office development to ensure that new job opportunities are matched to the employment needs of San Francisco residents.

Such an approach would slow down permitted office growth in the Eastern Neighborhoods—which is not likely to proceed rapidly in any event, based on past trends—and preserve PDR businesses in the short term better than the existing zoning. It would also ensure that the office development that would occur in the future would support the City's economic goals of maximizing quality job opportunities for residents of every educational level.

This approach is currently being pursued with the new Integrated PDR (iPDR) concept. Owners of iPDR buildings will be required to accept deed restrictions, limiting who can occupy them. Tenants in iPDR buildings will be required to work with the Office of Economic and Workforce Development to understand business incentives and workforce development programs, and work towards hiring targets.

These are excellent ideas to promote a targeted economic development strategy that is focused on the City's real economic problems. Unfortunately, iPDR covers far too narrow a segment of the economy to make a significant impact on jobs. There is no reason not to apply those same policy tools to a much broader set of potential employers—

including office employers—to create much broader positive impact on the job prospects facing San Francisco residents.

For example, San Francisco used to house most of the region's back-office employment, which offers middle-class wages to workers, particularly female workers, without extensive education.

Another well-known feature of San Francisco's office market is the increasingly small-size of its tenant base. As companies founded here grow, they often relocate to the suburbs in search of lower-cost office space, taking a wide variety of office jobs with them.

These jobs have largely moved to the suburbs, where they are based in suburban office parks that workers overwhelmingly commute to in private automobiles. As automobile commuting becomes more expensive in the future, San Francisco's central location and legacy of investment in regional transit will make it a more competitive location for these and other jobs.

In this context, if the proposed re-zoning is accepted, the City should consider expanding permissible office development elsewhere in San Francisco, ideally to level lost by the re-zoning in the Eastern Neighborhoods.

Economic and Fiscal Impacts of Fees

This report has also identified a short term fiscal risk to the City, in the form of lost potential incremental property tax revenue if the proposed fees and inclusionary requirements delay construction.

Ultimately, policymakers should be aware of a basic fiscal tradeoff. The fiscal strategy of using impact fees as a way of generating revenue for community benefits needs to be weighed against the incremental property tax that would be lost if projects are delayed.

The OEA's best estimate, given current market conditions, suggests that the current fees would delay a now-feasible project by two to four years. During that time, the lost incremental property tax revenue, received by the City and other public entities, would exceed the value of the fees and enhanced inclusionary requirements generated at the end of that delay.

In terms of risk mitigation, the impact fees are currently proposed to escalate annually, in accordance with the Construction Cost Index prepared by *Engineering News*. In the near future, this could lead to fees rising while housing prices continue to decline, seriously affecting project feasibility. This risk could be minimized by indexing the fees to *either* the Construction Cost Index, or the OFHEO Housing Price Index for San Francisco, whichever is less in a given year.

APPENDIX A: BUILDOUT MARKET ASSUMPTIONS

In an earlier section of this report the OEA estimated the build-out of the formerly industrially zoned parcels of the Eastern Neighborhoods. This appendix summarizes the assumptions used in that analysis.

Table 1 below describes assumptions used in estimating residential developments for the build-out model.

TABLE 1 **Residential Market Assumptions**

Existing Inclusionary Requirement	20%[23]
Sales Expenses	3.5%
Maximum feasible density	200
Proposed Development Impact Fee - Residential	8 per gross Sq. Ft.
Efficiency Factor - Net to Gross Sq. Ft.	85%
Proposed Development Impact Fee - Residential	9.41 per net Sq. Ft.
Gross Height per story Ft.	10
Lot Coverage Ratio	65%

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[23] Assuming provided off-site (inclusionary fee inlieu paid)

Table 2 below describes the assumptions used in calculating development costs, values, and inclusionary fees for low-rise residential units.

TABLE 2 **Development Cost and Value Assumptions: Low-Rise - Up to 50' (5 floors)**

Unit Type[24]	% of Units	Avg. Unit Size net Sq.Ft.	Avg. Value per Sq. Ft.	Avg. Value per unit	Avg. Cost per Unit	Inclusionary Fee per Unit
One BR	50%	750	$800	$600,000	$356,250	$248,210
Two BR	40%	950	$750	$712,500	$427,500	$334,478
Three BR[25]	10%	1,500	$700	$1,050,000	$637,500	$374,712
Weighted Average		905	$770	$690,000	$412,875	$295,367
Efficiency Factor - Net to Gross sq.ft.						85%
Average Unit Size - Gross Square Feet						1,064

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[24] Note: Based on KMA June 2008 sensitivity analysis, all figures in net Sq.Ft.

[25] Note: Development costs, unit sizes and finished values are based on KMA June 2008 sensitivity analysis. The EN Plan encourages 10% 3 bedroom units and mandates 40% of the units be 2 bedroom; this unit mix was used to calculate average unit size, weighted inclusionary fees. development cost, etc. Inclusionary Fees based on July 2008 Mayor's Office of Housing update.

Table 3 below describes the assumptions used in calculating development costs, values, and inclusionary fees for mid-rise residential units.

TABLE 3 **Development Cost and Value Assumptions: Mid-Rise - Up to 85' (6-9 floors)**

Unit Type	% of Units	Avg. Unit Size (net Sq.Ft.)	Avg. Value per Sq. Ft.	Avg. Value per unit	Avg. Cost per Unit	Inclusionary Fee per Unit
One BR	50%	800	$900	$720,000	$480,000	$248,210
Two BR	40%	1,000	$850	$850,000	$550,000	$334,478
Three BR	10%	1,600	$800	$1,280,000	$840,000	$374,712
Weighted Average		960	$870	$828,000	$544,000	$295,367
Efficiency Factor - Net to Gross Sq. Ft.						85%
Average Unit Size - Gross Sq. Ft.						1,129

Table 4 below describes assumptions used in estimating office development for the build-out model.

TABLE 4 **Office Market Assumptions**

	Less than 5 floors	5 or more floors
Lot Coverage Ratio	80%	80%
Annual Gross Rent per Sq. Ft.	$45	$47
Less Expenses per Sq.Ft.	-15	-15
NOI per Sq.Ft.	30	32
Cap Rate	7%	7%
Value per Sq.Ft.	$429	$457
Cost per Sq.Ft.	$375	$400

Table 5 below describes assumptions used in estimating PDR development for the build-out model.

TABLE 5 **PDR Market Assumptions**

	Up to 5 Floors	Over 5 Floors
Lot Coverage Ratio	80%	80%
Annual NNN Rent	$10.8	$10.8
Cap Rate	8%	8%
Value per Sq.Ft.	$135	$135
Cost per Sq.Ft.	$225	$225
PDR Building Sq. Ft. per Sq. Ft. lot area	80%	---

Table 6 below describes assumptions used in estimating laboratory development for the build-out model.

TABLE 6 **Laboratory Market Assumptions**

Lot Coverage Ratio	80%
Annual Gross Rent per Sq. Ft.	$57.5
Less Expenses per Sq.Ft.	-20
NOI per Sq.Ft.	37.5
Cap Rate	7%
Value per Sq.Ft.	$536
Cost per Sq.Ft.	$500

APPENDIX B: DEVELOPMENT ASSUMPTIONS FOR FEE IMPACT

Table 1 below details the assumptions used in estimating the impact of higher fees and inclusionary housing.

TABLE 1

Assumptions	*Scenario 1* Existing CM Zoning - No Impact Fee	*Scenario 2* UMU Zoning - No Impact Fee	*Scenario 3* UMU Zoning - With Impact Fee
Lot Area (Sq.Ft.)	25,000	25,000	25,000
Lot Area per Unit	200	200	200
Gross Height per story (ft.)	10	10	10
Number of Floors	5	5	5
Lot Coverage Ratio	65%	65%	65%
Total Units	**76**	**76**	**76**
Average Unit Size - Net SF	905	905	905
Average Unit Size - Gross SF	1,065	1,065	1,065
Finished Value Per Unit	**$690,000**	**$690,000**	**$690,000**
Development Cost per Unit	**$412,875**	**$412,875**	**$412,875**
Inclusionary Housing Requirement (offsite)	**20%**	**23%**	**23%**
Average Inclusionary Fee	$295,367	$295,367	$295,367
Inclusionary Fee per Unit	**$59,073**	**$67,935**	**$67,935**
Development Impact Fee (per Gross Sq.Ft.)	$0.00	$0.00	$8.00
Development Impact Fee (per unit)	**$0.00**	**$0.00**	**$8,518**
Sales Expenses (% of value)	3.5%	3.5%	3.5%
Minimum Required Return on Cost	18.0%	18.0%	18.0%
Land Cost Per Unit	Varies	Varies	Varies

Total units calculated based on height restrictions, lot area per unit, and average unit size of proposed unit mix. The maximum density, calculated based on lot area divided by lot are per unit, would result in 125 units. However, these units could not physically fit on the parcel (at 25 units per floor, the average size would need to be 1,000 Sq.Ft., not accounting for circulation, open space requirements, etc.). A lot coverage ratio of 65% was used to account for the average unit size, height limit, circulation, setback, and open space requirements.

Development costs, finished values, and return requirements based on KMA June 2008 sensitivity analysis.

All above assumptions based on the following unit distribution: 50% 1BR, 40% 2BR, and 10% 3BR. This distribution is used to calculate the weighted average size, inclusionary fee, development cost, etc.

STAFF CONTACTS

Ted Egan, Chief Economist (ted.egan@sfgov.org) (415) 554-5268
Kurt Fuchs, Senior Economist (kurt.fuchs@sfgov.org) (415) 554-5369
Todd Feiler, City Hall Fellow (todd.feiler@sfgov.org) (415) 554-5159